

WATER'S EDGE

KEY FACTS

No State Requires Worldwide Reporting. Without the water's edge election, California would be the only state to require worldwide combined reporting. All states that impose a corporate income tax and require filing under a combined reporting basis allow for taxpayers to report on a water's edge basis, and some require it exclusively.

Protects International Trade. The water's edge election eases international tensions on trade by allowing California to tax income earned within the United States. Foreign governments do not believe that California should infringe upon trade agreements between the United States and foreign governments.

Protects Against Double Taxation. Foreign governments argue that elimination of water's edge will lead to double taxation. In some cases, taxpayers could be required to report taxable income that already is taxed by foreign governments.

Simplifies Compliance. The water's edge election minimizes compliance problems, such as currency conversions and restrictions, and differences in international accounting standards. Multinational taxpayers have affiliated entities spanning the globe, and under a worldwide reporting system, this would require the Franchise Tax Board to audit overseas records.

CALIFORNIA'S APPROACH TO TAXING FOREIGN INCOME

During the 1970s and 1980s, California's method of taxing business income created tension in the international community. In their view, California was infringing upon international trade agreements. California taxed income on a worldwide "unitary" basis, which meant that the income earned by foreign affiliates was subject to California's reporting and apportionment formula. Today, California offers business taxpayers two options to report taxable income for purposes of the state's corporate income tax:

- **Worldwide Combined Reporting.** Taxpayers doing business in California can report income earned by each member of a unitary group from all worldwide sources.
- **Water's Edge.** Taxpayers doing business in California can elect to exclude income and factors of non-U.S. affiliates when apportioning income to California. When choosing the election, a taxpayer must agree to file on this basis for 84 months.



"The water's edge election provides assurance that the affiliates of foreign-based companies filing on a water's edge basis in California will not be taxed on the same income both in a foreign country in which they are doing business and in California. It is our view that, to facilitate a positive environment for California-European trade, the states should act in a manner that is consistent with prior commitments made by the state and federal government to their European trading partners."

– Kingdom of the Netherlands, Letter to the California Legislature, April 2010.